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No. 371

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN H. SMITH

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in this case.

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 21–37) is not officially reported. The opinion of the Circuit Court of Appeals is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 25, 1944 (R. 176). The jur-

isdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, upon the receipt of stock purchased under an option granted to the respondent in an earlier year as compensation for personal services, the respondent realized taxable income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code, in the amount of the excess of the fair market value of the stock at the time of acquisition over the option price.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Section 22 (a) of the Internal Revenue Code (26 U. S. C., Sec. 22), applicable to 1939, is identical.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 22 (a)–1. *What included in gross income.*—
>
> * * * * *
>
> If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock, as to which see article 22 (a)–8.
>
> * * * * *

Section 19.22 (a)–1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, is identical.

STATEMENT

The following are the relevant facts as found by the Tax Court (R. 22–30):

The respondent, an individual, had for many years been employed by the Western Cooperage Company ("Western"); and at the time of the hearing before the Tax Court was its general manager (R. 22). At the request of a bondholder's committee of the Hawley Pulp and Paper Company ("Hawley"), which had been in financial difficulties before 1933, Western took over the management of that corporation (R. 22–23). The respondent was personally active in the reorganization of Hawley, which took place in 1934 (R. 23). He interviewed many of the holders of Hawley securities and obtained the deposit of a substantial amount of securities under the reorganization plan (R. 23). Under the plan adopted, Western was to continue, at its option, to manage Hawley so long as it was not in default under the plan, which provided that the management, under Western, was to retire certain amounts of indebtedness each year (R. 23).

Western was to be compensated for management services by receiving from a depositary of

Hawley stock, after the retirement of $1,400,000 of Hawley's total indebtedness of $2,790,150, a proportion of the total number of shares deposited equal to the proportion of the total indebtedness retired (R 23–24).

To reward respondent for the services which he had rendered in connection with the reorganization, Western's president and general manager granted him an oral option in December 1934 (R. 24). On the advice of counsel, Western in May 1937 adopted a corporate resolution authorizing the execution of a formal written option embodying the terms of the oral option (R. 24). The resolution stated that the option was granted to the respondent (R. 24)—

> in consideration of his services theretofore rendered in negotiating the plan of reorganization of Hawley Pulp and Paper Company and in bringing about the deposit of securities enabling the confirmation of said plan * * *.

The written option executed pursuant to the resolution was dated as of December 10, 1934, and contained a similar recitation of the consideration for which it was given (R. 25). It conferred upon respondent the right to purchase, on or before January 1, 1940, Western's rights in a portion of the shares on deposit (R. 25) at a price which was found by the Tax Court to have been not less than the market value of the shares

at the time when the oral option was granted (R. 27–28). The option provided that if by reason of management defaults Western should be entitled to receive only a portion of the deposited Hawley stock, Western would upon exercise of the option file with the depositary a written notice that it had sold its right to receive the stock subject to the option and would order the depositary to deliver to the respondent a portion of the stock which it would be entitled to receive, in approximately the ratio which the stock subject to the option bore to the entire amount of stock on deposit (R. 26–27).

On or before March 18, 1938, Western reduced the outstanding indebtedness of Hawley by $1,409,720 (R. 27). On that date the respondent exercised his option, paying Western $7,437.70 for its rights with respect to the stock here involved (R. 27); and Western directed the depositary to deliver stock to the respondent (R. 28). On the following day, March 19, 1938, the respondent received from the depositary Hawley stock having a fair market value of $81,021.60 more than the portion of the price paid under the option allocable thereto; and during 1939 he received Hawley stock as to which such excess was $71,663.98 (R. 28, 29).

The Commissioner determined that such amounts constituted taxable income to the respondent in the respective years. The Tax Court

sustained this determination on the ground that the amounts represented compensation received for personal services (R. 21–37). The court below reversed (R. 176).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court erred in holding that the respondent did not receive taxable income in the amount of the excess of the market value of the stock when received over the option price, and in reversing the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

We believe that the decision below conflicts with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Connolly's Estate* v. *Commissioner*, 135 F. (2d) 64. In that case as here, the taxpayer received an option to purchase stock as compensation for services, and exercised the option in a later year when the market price had risen. It was held that the entire excess of the market price at the time of purchase over the option price constituted taxable income in the year of purchase.

The court below apparently sought to distinguish that decision on the ground that there the market price exceeded the option price both at the time of the granting of the option and at the time of its exercise (R. 174). This additional circumstance does not negative the existence of a conflict, however, since it was held in the

Connolly case that the taxpayer had received income not merely in the amount of the spread at the time the option was granted, but in the amount of the greater spread at the time it was exercised. The controlling circumstance was that the option was given as compensation for personal services. In this essential respect that case is identical with the present. The Tax Court expressly found (R. 24, 25), and the circuit court of appeals conceded (R. 174), that the option in the present case was granted for the very purpose of paying compensation for personal services. As the Tax Court observed, that fact was indisputable, for it was so stated in the corporate resolution and in the option itself, and the taxpayer testified to the same effect (R. 33). The option could not have been intended as compensation unless it was contemplated that the respondent would profit by a rise in the market value of the stock, which was continuously quoted on the local exchange (R. 102). The market value of the stock at the time the option was given was not in excess of the option price (R. 27–28); moreover, the option related only to the right of Western to receive Hawley stock (R. 25), which right was contingent upon the fulfillment by Western of the conditions embodied in the plan of reorganization (R. 26). Thus it is evident that here, as in the *Connolly* case, the taxpayer was meant to be compensated by a favorable exer-

cise of the option. That the cases are not distinguishable was the conclusion of the Tax Court (R. 32–23).

The decision by the court below was not required by any decision of this Court. In *Palmer* v. *Commissioner*, 302 U. S. 63, relied upon below by the respondent, the issue was whether there was a taxable dividend where a corporation issued to the stockholders options to purchase assets at a price which did not appear to be below the market price at the time of issuance. After issuance of the options the market price rose. The Board of Tax Appeals found that there was no intention to distribute any earnings of the corporation to its stockholders (302 U. S. at p. 67). This Court held that to establish that such a transaction amounts to a dividend (p. 70)—

> it is at least necessary to make some showing that the transaction is in purpose or effect used as an implement for the distribution of corporate earnings to stockholders.

Cf. *Choate* v. *Commissioner*, 129 F. 2d 684 (C. C. A. 2d); *Gibson* v. *Commissioner*, 133 F. 2d 308 (C. C. A. 2d), petition for a writ of certiorari dismissed, 320 U. S. 805. In the present case, on the other hand, the transaction in its purpose and effect constituted the award of compensation to the taxpayer.

The question presented is of importance in the administration of the law. The Bureau of Internal Revenue has informed us that devices like that here involved are being used with considerable and increasing frequency, in the apparent expectation of minimizing tax liability by payment of tax at capital gain rates on sale rather than at ordinary income rates,[1] and with the view also of circumventing restrictions imposed by the salary stabilization program;[2] and that serious administrative difficulties have resulted. We believe that a decision by the Court in this case would be in the public interest.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

AUGUST 1944.

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[1] The effect of such a device upon liability for income taxes comes into question in a variety of situations: Where, as in this case, the employee denies that the excess of market value over price paid constitutes ordinary income; where the employer seeks to deduct the amount of the excess as a business expense; and where the property purchased is subsequently sold, raising questions of basis and of the period for which the stock was held.

[2] See Sec. 1002.6 of T. D. 5295, 1943 Cum. Bull. 1193.

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